FILED
OCT 25 1932
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No. 475

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

S. & L. BUILDING CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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No. ——

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

S. & L. BUILDING CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of David Burnet, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit, entered in the above cause on July 25, 1932, reversing the decision of the Board of Tax Appeals.

QUESTION PRESENTED

Whether the first sentence of the last paragraph of Article 44 of Treasury Regulations 69, as amended, pp. 16–17, *infra*, is a valid regulation.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, pp. 15–17, *infra*.

STATEMENT

The facts material to the present issue, as found by the Board of Tax Appeals (R. 59–68), may be summarized as follows:

The respondent is a New York corporation engaged in the real estate business in New York City. During 1925 and prior years it obtained loans secured by mortgages upon its properties in order to finance its business. (R. 59–60.) It kept its books and made its income-tax returns upon the accrual basis. (R. 60.)

The respondent owned two pieces of property located, respectively, at 82nd Street and Broadway and 83rd Street and Broadway, which were acquired by it after March 1, 1913. The 82nd Street property was sold in 1924 for $2,100,000, of which $300,000 was paid in cash. For the balance of the purchase price the purchaser assumed a first mortgage of $1,100,000 and gave a purchase-money mortgage of $700,000. The depreciated cost of the property at the time of sale was $1,541,323.48, making a total profit on the sale of $558,676.52. In addition to the cash payment of $300,000, the respondent received installments on the purchase-money mortgage during 1924 in the amount of $30,000, and during 1925 in the amount of $36,250. During 1924 and 1925 the purchaser paid to the holders of

the first mortgage, in accordance with the terms of sale, $22,000 and $44,000, respectively, the first mortgage being payable in installments of $22,000 each, due every six months beginning December 1, 1924, until April 9, 1933, when the entire balance becomes due and payable. (R. 63–64.)

The 83rd Street property was sold in 1925 for $2,165,000, of which $300,000 was paid in cash. For the balance of the purchase price the purchaser assumed a first mortgage of $1,100,000 and a second mortgage of $500,000 and gave a purchase-money mortgage of $265,000. The depreciated cost of this property at the time of sale was $1,522,033, making a total profit on the sale of $642,967. In addition to the $300,000 cash payment, the respondent received in 1925 $2,000 upon the purchase-money mortgage. The first and second mortgages assumed by the purchaser exceeded the depreciated cost of the property to the respondent by the amount of $77,967. In 1925 the purchaser paid to the holders of the second mortgage the sum of $22,500. The first mortgage provided for payment in installments of $16,500 each, due May 1, 1926, and every six months thereafter until April 9, 1933, when the entire balance becomes due. The second mortgage provided for payment in installments of $7,500 each, due May 7, 1925, and every three months thereafter until November 7, 1934, when the entire balance becomes due. (R. 64–66.)

The Commissioner of Internal Revenue, in determining the respondent's tax liability for 1924 and

1925, computed the income from the sale of the two pieces of property on the installment basis. In computing the income upon such basis the Commissioner did not include as a part of the "initial payments" or of the "total contract" price the amount of the mortgages assumed by the purchasers. He included as part of the income received in 1925 from the sale of the 83rd Street property the amount by which the mortgages assumed exceeded the depreciated cost. By this method the Commissioner determined that the profit realized in 1924 on the sale of the 82nd Street property was $184,363.25, computed as follows (R. 66):

Profit to be realized	$558,676.52
Contract price	1,000,000.00
Percentage of profit to contract price	55.86752%
Cash payment plus installments received on purchase-money mortgage	330,000.00
55.86752% times $330,000 equals	184,363.25

Applying the same percentage to the installments of $36,250 received in 1925 on the purchase-money mortgage on the 82nd Street property, the Commissioner determined the realized profit for 1925 on that sale to be $20,252.02. (R. 66.)

By the same method the Commissioner determined a realized profit for 1925 on the sale of the 83rd Street property of $379,967, computed as follows (R. 67):

Profit to be realized	$642,967
Contract price	565,000
Percentage of profit to contract price	100% plus
Initial payment	300,000
Installments on purchase-money mortgage	2,000
Excess of mortgages assumed over depreciated cost of property	77,967
Profit realized in 1925	379,967

The Board of Tax Appeals approved the Commissioner's method of computing the profits realized in 1924 and 1925 from the sales of the 82nd Street and 83rd Street properties[1] (R. 71–72), but upon appeal the Circuit Court of Appeals reversed the decision of the Board, the court holding that Article 44 of Regulations 69, upon which the Commissioner based his computations, was not a proper interpretation of the statute (R. —).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred: 1. In holding that Regulations 69, Article 44, in so far as it relates to the manner of computing income from the sale of real estate upon the installment basis, is invalid.

2. In not holding that Article 44, Regulations 69, is valid and in not applying the method of computation therein prescribed.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals that Article 44 of Regulations 69, so far as it is applicable to the instant case, is invalid conflicts in principle with the decision of the Circuit Court of

[1] The Commissioner had determined deficiencies of $394.69 and $33,947.39 for 1924 and 1925, respectively. (R. 12, 35.) Although the Board sustained the Commissioner with respect to the issues raised in this petition, its determination in favor of the taxpayer of other issues, not here involved, resulted in an order of no deficiency for 1924 and a deficiency of $29,645.85 for 1925. (R. 74–80.)

Appeals for the Sixth Circuit in *Lucas* v. *Schneider*, 47 F. (2d) 1006, certiorari denied, 284 U. S. 622, wherein the same regulation was held valid. The resulting uncertainty as to the validity of the regulation has caused confusion in the administration of the applicable statute.

2. The question decided by the Circuit Court of Appeals is of importance in the administration of the tax laws. The provisions of the regulation in question were made retroactive for all years beginning with 1916, and substantially identical provisions are contained in Regulations 74, issued under the 1928 Act. A large number of returns have been audited on the basis of the regulation, the application of which has been uniformly sustained by the Board of Tax Appeals. The decision of the court below, if permitted to stand, will result in the filing of numerous refund claims and suits and in the reopening of many cases already audited, as well as in the raising of new issues and the assertion of increased deficiencies in cases now pending before the Board.

3. The decision of the Circuit Court of Appeals establishes a method of computing income in connection with the sale of real estate upon the installment basis which is inconsistent with the general scheme of accounting contemplated by the Revenue Acts and is impracticable of administration, since it requires both taxpayers and the Bureau of Internal Revenue to determine income

not by reference to the taxpayers' own books and records, but by making collateral inquiries each year with regard to the amount of payments received by the various holders of assumed mortgage obligations.

Wherefore it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

OCTOBER, 1932.

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BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. —) is reported in — F. (2d) —. The findings of fact and opinion of the Board of Tax Appeals (R. 57–73) are reported in 19 B. T. A. 788.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 25, 1932. (R. —.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED, STATUTES INVOLVED, ETC.

The question presented, specification of errors to be urged, and a statement of the case will be found in the petition. The statutes and regulations involved will be found in the Appendix, pp. 15–17, *infra*.

ARGUMENT

The Circuit Court of Appeals held that in computing the annual realized profit from the sale of real estate on the installment basis, as permitted by Section 212 (d) of the Revenue Act of 1926, pp. 15–16, *infra*, the "installment payments actually received" must include payments by the purchaser to the holders of existing mortgages, assumed as part of the purchase price, as well as all payments to the seller, and that the amount of such assumed mortgages, as well as cash payments and purchase-

money mortgages given, must be included in "the total contract price," which is the determining factor in arriving at the proportion of annual receipts to be reported as realized income. The rule thus laid down is directly contrary to Article 44 of Treasury Regulations 69, pp. 16–17, *infra.*

Section 212 (d) authorizes the return upon the installment basis, under regulations prescribed by the Treasury Department, of income from a sale of real estate where the "initial payments" do not exceed one-fourth the "purchase price." The statute provides that the taxpayer may return as income from such a sale that proportion of "the installment payments actually received" in the taxable year, "which the total profit realized or to be realized when the payment is completed bears to the total contract price." Quite obviously Section 212 (d) provides only for the simple and usual case of sales of property upon the installment plan and designates the method to be used in determining annual income therefrom. By that Section Congress did not undertake to prescribe meticulously the formula to be employed or to define the factors to be applied in all cases, especially the more complex sales of real property subject to existing mortgages.

Article 44, Regulations 69, adopted pursuant to express authority contained in Section 212 (d), provides that the amount of assumed existing mortgages shall be included in the "purchase price" but, to the extent they do not exceed the "basis" (for

determining gain or loss), they shall not be included as part of "the initial payments" or of "the total contract price." Under the rule thus prescribed the amount of assumed mortgages, while considered a part of the total consideration for the sale, is excluded from "the total contract price," which is taken to mean the aggregate payments to be received *by the seller alone.* Likewise, payments on the assumed mortgages are excluded from the "installment payments actually received," which latter phrase is taken to mean only installment payments received by the seller alone. The excess, if any, of the assumed mortgages over the "basis" is treated as income realized at the time liability is assumed by the purchaser.

The regulation, we believe, gives effect to the intent of the statute and is a correct interpretation of it. The purpose of the statute undoubtedly was to permit deferring the return for taxation of the realized gain on a completed transaction of the character described until the actual receipt of cash or its equivalent by the taxpayer. The regulation effectuates this purpose by treating as income a ratable amount of the payments actually received by the taxpayer alone, exclusive of any payments made to third persons as holders of mortgages assumed by the purchaser.

Inconsistency in the regulation suggested by the court below is more apparent than real. The excess of assumed mortgages over the "basis" is properly treated as realized income to the taxpayer

at the time of assumption of liability by the purchaser, for the taxpayer is, as between himself and the purchaser, then relieved of liability; and to the extent of such excess, theretofore received as a loan, the taxpayer has at that time derived income, under the principle of *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. No inconsistency results from excluding the remainder of the assumed mortgages from the "total contract price" and the payments thereon from "installment payments actually received," for payments on such mortgages are not to be made to the taxpayer; and while counted in full as part of the total consideration for the sale, the assumption of the mortgages to the extent not in excess of the "basis" may properly be treated as a return of the "basis," and hence excluded from both factors of the ratio applicable in computing the amount of income realized by the taxpayer from each installment payment.

The decision below, we submit, does not conform to the statute and fails to give effect to its purpose. Under the construction adopted by the court, the terms "installment payments actually received" and "total contract price" bear no relation to receipts by the taxpayer (seller), but are measured by payments made by the purchaser to both the taxpayer and third persons, holders of the mortgages assumed. As a result the taxpayer may be required to report income in a year in which he has received nothing and even in years long after he has received all payments due him. Such a result is inconsist-

ent with the general scheme of accounting contemplated by the Revenue Acts and measures the tax payer's income, to some extent at least, by the receipts of another. This, it is believed, was not contemplated by Congress, which must have intended apportioning only the payments received by the taxpayer. If, as the Circuit Court of Appeals holds, the assumed mortgages must be included in the "total contract price," consistency requires that the amount thereof also be included in the "initial payments." In that event, the initial payments in each sale here involved would exceed one-fourth the purchase price, as will be true in practically all such cases, so that the benefit of the installment basis of reporting income conferred by the statute could not be claimed by the respondent.

Moreover, the decision of the court below presents great difficulties of administration. Under that decision it is necessary to take account of the payments made by the purchaser in each year, not only to the taxpayer but also to the holders of the mortgages, which latter payments are not necessarily reflected on the taxpayer's books. The obstacles thus confronting the Treasury Department in the proper audit of the returns of the taxpayer and in the assessment and collection of taxes are obvious. These obstacles are even more serious in the event of subsequent transfers of the mortgages and of the property by successive purchasers.

The decision of the court below is in conflict in principle with *Lucas* v. *Schneider,* 47 F. (2d) 1006 (C. C. A. 6th), certiorari denied, 284 U. S. 622, in which case the court upheld the validity of the regulation which the court below held invalid. It was there held that the *excess* of the assumed mortgages over the "basis" should be included in the "initial payments," excluding the remainder of such mortgages, as provided by the regulations. In that case the initial payments computed in accordance with the regulations exceeded one-fourth of the purchase price, and it was held that the income could not be reported on the installment basis.

The regulation nullified by the decision of the court below has been consistently upheld by the Board of Tax Appeals. See *Appeal of Bosshardt,* 4 B. T. A. 1262; *Appeal of Dalriada Realty Co., Inc.,* 5 B. T. A. 905; *Pacheco Creek Orchard Co.* v. *Commissioner,* 12 B. T. A. 1358; *McWilliams* v. *Commissioner,* 15 B. T. A. 329; *Watson* v. *Commissioner,* 20 B. T. A. 270; *Fifty-three West Seventy-second Street, Inc.,* v. *Commissioner,* 23 B. T. A. 164; *Metropolitan Properties Corp.* v. *Commissioner,* 24 B. T. A. 220. Moreover, the statute to which the regulation applies was substantially reenacted in the Revenue Act of 1928, c. 852, sec. 44, 45 Stat. 791, 805, and in the Revenue Act of 1932, Section 44, Public No. 154. Regulations 74, Art. 352, applicable to the 1928 Act, repeat, so far as presently material, the regulations now in

question. Under these circumstances, the administrative interpretation of the statute should not be disregarded. See *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488, 492; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *Brewster* v. *Gage*, 280 U. S. 327, 337.

CONCLUSION

The decision of this Court is required to prevent confusion in the administration of the statute which the decision of the court below creates. Therefore, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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OCTOBER, 1932.

APPENDIX

STATUTES AND REGULATIONS

Revenue Act of 1926, c. 27, 44 Stat. 9, 23, 41, 130:

SEC. 232. In the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206, and the net income shall be computed on the same basis as is provided in subdivisions (b) and (d) of section 212 or in section 226. * * * (U. S. C. App., Title 26, Sec. 984.)

SEC. 212. (b) The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * * * *

(d) Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceed-

ing $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made. (U. S. C. App., Title 26, Sec. 953.)

SEC. 1208. The provisions of subdivision (d) of section 212 shall be retroactively applied in computing income under the provisions of * * * the Revenue Act of 1924, * * *. (U. S. C. App., Title 26, Sec. 953 (a).)

Treasury Regulations 69:

ART. 44. *Sale of real property involving deferred payments.*—Under section 212 (d) deferred-payment sales of real property fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed one-fourth of the purchase price.

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed one-fourth of the purchase price.

Sales falling within class (1) and class (2) alike include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the purchase price has been paid, and (b) sales where there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "purchase price," but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 212 (d), in articles 42 and 45, and in this article. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments," the "total contract price," or the "purchase price." (As amended by Treasury Decision 4255, approved January 8, 1929, Internal Revenue Cumulative Bulletin VIII–1, p. 165.)

ART. 45. *Sale of real property on installment plan.*—In transactions included in class (1) in article 44 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1932